

Taking Back Our Fiscal Future

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Members of the Brookings-Heritage Fiscal Seminar have joined together to issue this paper because of the importance they attach to gaining control of our nation's fiscal future. However, the ideas expressed are their own and do not represent the views of the organizations with which they are affiliated. Support from the Corporate Advisory Committee of the Brookings Budgeting for National Priorities Project, the Annie E. Casey Foundation, William and Flora Hewlett Foundation, Charles Stewart Mott Foundation, and Gordon V. and Helen C. Smith Foundation is gratefully acknowledged.

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Preface

The authors of this paper are longtime federal budget and policy experts who have been drawn together by a deep concern about the nation's long-term fiscal outlook. Our group covers the ideological spectrum. We are affiliated with a diverse set of organizations. We have been meeting informally for over a year, under the auspices of The Brookings Institution and The Heritage Foundation, to define the dimensions and consequences of the looming federal budget problem, examine alternative solutions, and reach agreement on what should be done. Despite our diverse philosophies and political leanings, we have found solid common ground. We agree that:

- Unsustainable deficits in the federal budget threaten the health and vigor of the American economy.
- The first step toward establishing budget responsibility is to reform the budget decision process so that the major drivers of escalating deficits—Social Security, Medicare, and Medicaid—are no longer on autopilot.

More specifically, we recommend that:

- Congress and the president enact explicit long-term budgets for Medicare, Medicaid, and Social Security that are sustainable, set limits on automatic spending growth, and reduce the relatively favorable budgetary treatment of these programs compared with other types of expenditures.
- The programs be reviewed on a regular schedule by the Social Security and Medicare Trustees or the Congressional Budget Office to determine whether they will remain within budgeted amounts.
- Significant long-term deviations from budgeted amounts trigger automatic adjustments in benefits, premiums, provider payments, or other revenues. These adjustments could only be over-ridden by an explicit vote of Congress and acceptance by the president.

We provide examples of specific policies that might be adopted to bring the programs in line with their long-term budgets but believe that the first action needed to restore long-term fiscal balance is a change in the way budget decisions are made.

The remainder of this paper describes why we think this change is so important and what the next steps should be.

The huge problem the candidates are *not* talking about

When the next president and Congress take office in January 2009, they will face one crucial question that has been largely absent from the current election campaign: how to narrow significantly the enormous gap between projected federal spending and revenues. The relatively modest deficits of the recent past – \$163 billion or 1.2 percent of GDP in fiscal 2007 – are now history, since deficits are expected to rise rapidly in the near-term. Moreover, projected increases in spending for Medicare, Medicaid, and Social Security will soon create unsustainable deficits unless current policies are changed. Furthermore, the automatic growth in these programs is preempting the policy discussion we should be having about our national priorities and how they should be funded.

Without addressing upfront this automatic spending growth and the deficits they engender, our newly elected leaders in 2009 will have little chance to meet the challenges that Americans face in a world of intense global competition and rapidly changing technology. We are particularly worried that automatic growth in programs directed primarily at seniors will crowd out growth-enhancing investments in the skills and well-being of the young. In the next few years, our political leaders will have to make the decisions necessary to achieve fiscal sustainability while meeting the needs of an aging society, honoring other obligations, addressing new challenges as they arise, and maintaining a dynamic, growing economy. Voters deserve to know that the leaders they elect this fall understand the seriousness of the budget challenge and are prepared to work with each other and the public to craft solutions.

Our political leaders have been avoiding this enormous issue—largely because it requires that the public be told that not all past promises can be met. Our group has come together, from diverse points on the political spectrum, to sound an alarm: if America is to remain strong, such evasions must end.

The year 2008 is not just an election year; it also marks the beginning of a demographic transformation as the first of nearly 80 million baby boomers reach the age at which they can draw Social Security benefits. Social Security, Medicare, and Medicaid—whose benefits in large measure are focused on the elderly—already comprise 42 percent of the federal budget even before the baby boomers begin to retire.

Compounding the effects of that demographic shift, health care spending continues to rise far more rapidly than income and other spending. Over the past 40 years, it has consistently grown roughly one-third faster than the economy. If the same growth rate continues over the next 40 years, Medicare and Medicaid alone will equal as large a fraction of our nation's economy as the entire federal budget does today.

In short, over the coming decades, maintaining current policy in the three big entitlement programs—Social Security, Medicare, and Medicaid—will drive federal spending up much faster than revenues, opening up a widening gap between the two. The rapid automatic growth in those programs is already absorbing more and more resources that could be allocated to other priorities. If present trends continue, the nation's deficit will reach unmanageable proportions, other vital public needs will be further squeezed, and/or taxes will have to rise continuously to levels that could restrict economic growth.

In light of these realities, we believe that achieving fiscal sustainability requires a fundamental change in the budget decision process. We need to start with the three big entitlement programs that drive federal spending. Their costs rise without any explicit vote or decision, simply because the number of people eligible for benefits goes up and the benefits received by each person become more expensive. We believe that these three programs must be subjected to serious periodic review and decision. Their estimated future costs must be shown clearly and budgeted in advance. If they run significantly over budget, a triggering mechanism should force the president and Congress to deal with the shortfall. This requirement would give the public and their elected representatives a chance to decide explicitly how much they want to spend on these three entitlements, how much on other priorities – such as national defense, education, and scientific research – and what level of taxes they are willing to pay to support these programs.

We are emphatically not disparaging either the purposes or the accomplishments of Social Security, Medicare, and Medicaid. America's social insurance systems have played an indispensable role in assuring decent living standards and health care for the elderly and the poor and have made America a stronger, more cohesive nation. However, so far we have failed to reform and modernize these programs in the face of the aging of the population and rapidly rising health care costs—or even to acknowledge that we must do so. Bringing these automatic budget drivers into more balanced competition with other public and private priorities is necessary if we are to set our country on a sustainable fiscal course and ensure a dynamic economy that will buffer Americans against the unavoidable shocks that will occur in both their working and retirement years. Our proposal for periodically reviewing program spending and triggering action on these programs when they run over budget is a first step in this direction.

Myths that perpetuate inaction

Our proposal to take Social Security, Medicare, and Medicaid off autopilot may seem radical to some, but the current budget system has allowed policy makers to avoid tough choices. Too many people are in denial about the coming budget crunch. They cling to favorite prescriptions for attaining fiscal sustainability and avoiding fundamental decisions about what the government should do and how its programs should be financed. They assert, “We just need to grow the economy faster” or “We just need to make government (or health care) more efficient” or “We just need to raise taxes.” Unfortunately, while each of these prescriptions can contribute to reducing the budget gap, none provides a real solution. Even if we follow *all* of these prescriptions, we will still face hard choices. And while we are all entitled to our opinions, we are all bound by a common set of facts.

Myth: *We can grow our way out of difficult budget choices.*

Reality: Strong economic growth will make the choices somewhat easier. Hence, it is important to resolve the budget problem and reform social insurance in ways that enhance growth. However, we cannot grow our way to a sustainable budget outlook. The Government Accountability Office calculates that—if present trends and policies continue—it would take decades of “double digit” growth rates to eliminate the deficit. But, because of the structure of Social Security, that growth in productivity and wages automatically translates into higher future benefits, offsetting a significant portion of the fiscal gains from a larger economy. In short, if the status quo continues and entitlement programs are not reformed, there is no feasible growth rate of the economy that will produce a sustainable budget path.

Myth: *Eliminating waste in government programs will solve the deficit problem.*

Reality: Improving the efficiency of government programs is important as a matter of fiscal responsibility and restoring trust in government, but it will not significantly reduce future deficits. It is an illusion to think that eliminating waste in government programs will come anywhere near closing the projected gap between spending and revenues. In fact, if present trends and policies continue—and the growth of entitlement programs is not restrained—even entirely eliminating all non-entitlement spending will not close the budget gap.

Myth: *The deficit problem can be solved by delivering health care more efficiently.*

Reality: Making the health system more efficient can slow the rate of growth of medical care spending and reduce the gap between federal spending and revenues. High priority should be given to eliminating wasteful health spending and increasing value obtained for

public and private health spending. However, even if these efforts are successful, medical care spending is almost certain to grow faster than the economy, and federal health spending will still grow faster than federal revenues.

Myth: *We just need to raise taxes starting with rolling back some or all of the Bush tax cuts.*

Reality: Higher taxes could contribute to paying part of the rising social insurance bill, but we cannot simply tax our way out of the problem. Even restoring tax rates to pre-2001 levels will not close the gap between spending and revenues. Raising taxes will not address the underlying forces—population aging and health care cost growth—driving spending and revenues apart in the coming decades. Even raising revenues as a percent of GDP to European levels—levels that are unprecedented in the United States—will not be sufficient. If the wedge between spending and revenues attributable to social insurance programs continues to grow, taxes would have to be raised continuously and would eventually cripple the economy. Finally, even if taxes were to be raised, it is not at all clear that Social Security, Medicare, and Medicaid should receive automatic priority for these resources over other needs such as education, homeland security, and infrastructure investments.

Myth: *Cutting taxes will increase revenues.*

Reality: Lowering tax rates can stimulate long-term economic growth, but at today's rates not by enough to pay for the lost revenue. Tax cuts used to stimulate the economy during a recession are a different matter, but they should be kept temporary and ideally should be paid for once the economy recovers.

Changing the budget decision process to force choices

The current budget decision process—complex, time-consuming, and controversial though it is—does not require that Congress and the president conduct a periodic review of how we are committing our limited resources across all of our competing priorities. Nor does it require that policy makers address the looming deficits in the federal budget or force decisions on how to close the gap between projected spending and revenues. Social Security, Medicare, and Medicaid, which are the major sources of future spending growth, are for the most part left out of the annual budget decision process. Their spending is usually taken as given, determined by the number of eligible participants and formulas that allow the lifetime benefits of the average beneficiary to grow at significant rates. Benefits and eligibility are reconsidered very infrequently, not on a regular basis. Benefits can be added—as prescription drug benefits were added to Medicare—without providing sufficient funding for their future costs, which could amount to trillions of dollars over time. Similarly, the proliferation of special provisions in the tax code are, for the most part, rarely reviewed and lead to the gradual erosion of the tax base with adverse effects on the efficiency and simplicity of the tax system.

The budget decision process, which determines spending for national security, education, housing, and other discretionary programs through the annual appropriations process, deals with a portion of the budget, but the allocation of limited resources across the full spectrum of national priorities—including the rapidly growing entitlement programs—is rarely addressed. The president and Congress do not have to decide the relative importance of supporting retirement income or medical care for the elderly versus investing in education, infrastructure, and research or meeting national defense or homeland security needs.

The first step toward creating a more level playing field and achieving long-run fiscal sustainability in the federal budget is to take the three major entitlement programs off autopilot. We recommend the following changes:

- **Congress and the president should enact explicit long-term budgets for Social Security, Medicare, and Medicaid that are sustainable, set limits on automatic spending growth, and have a required review every five years.** Since people depend heavily on these programs and plan their lives around them, they must be budgeted on a long-term basis and should not be adjusted frequently. Reviewing them every year like discretionary spending programs would cause too much uncertainty for retirees and place too great a burden on Congress. The three major entitlement programs should be budgeted for longer periods (for example, 30 years) but be subjected to review every five years. These five-year reviews would allow reconsideration of the trade-offs between entitlement spending and other purposes and might cause adjustments in benefits, premiums, taxes, or all three.
- **The rules for the five-year review must include a trigger or action-forcing device that requires explicit decisions when projected spending exceeds budgeted amounts.** The trigger might involve automatic benefit cuts or revenue increases (including premium increases) that could only be over-ridden by an explicit vote or enactment of alternative policies that would achieve budget outcomes similar to the automatic adjustments. Alternatively, the trigger process could require that a commission make recommendations for closing the gap to the president and Congress on which an up or down vote must be held. The trigger process that forces an explicit vote when the long-run budget for any of these programs is exceeded will dramatize the importance of modernizing these entitlement programs to reflect increased longevity, higher incomes, and the rising cost of medical care. If the public wants the increasingly expensive health benefits provided by Medicare and Medicaid because they judge them to be well worth the costs, then those benefits will have to be paid for with some combination of revenue increases and cuts in other spending.
- **The long-run costs of these three programs should be visible in the budget at all times and considered when decisions are made.** Benefits should not be increased—either at the five-year review or in between—without ensuring that they are fully financed.

The budget includes other mandatory or entitlement programs and tax subsidies that grow automatically without review. Ultimately we would like to bring all parts of the budget into a disciplined, transparent review process that forces politicians and the public to consider priorities and trade-offs among potential uses of federal resources. We recommend starting with the three major entitlement programs because they are the primary drivers of increased spending.

Approaches to reforming Social Security, Medicare, and Medicaid to ensure that they remain within budgeted amounts

At some point, Social Security, Medicare, and Medicaid will have to be modernized in response to the facts that Americans are living longer and are using more effective and expensive medical

care. Because Social Security is affected primarily by demographic changes, the options for reforming it are relatively straightforward.

For example, we could maintain the current structure of the program while raising the age at which benefits can be received and indexing it to future increases in longevity. In this context, we might also modify the formula for calculating initial benefits so that they grow less rapidly in the future, perhaps with much slower growth for those expected to have other retirement income. Alternatively, we might choose to change the basic structure of the program—for example, by shifting toward mandated savings in individual accounts or strengthening the relation between income and benefits.

There are many options on the revenue side as well. While retaining the payroll tax as the funding mechanism, we could raise the rate or increase the earnings subject to Social Security taxation. Other revenue options include: subjecting benefits more fully to income taxation, broadening the system to include currently exempted workers, or replacing or supplementing the payroll tax with a broad-based energy levy or other earmarked tax that would raise revenues.

Compared to Social Security, Medicare, and Medicaid present far more difficult challenges. While projections of their future costs are affected by demographics, they are dominated by the rising per capita cost of health care. Improving the efficiency of the health care delivery system—not just for Medicare and Medicaid patients, but for everyone—has the potential to slow the growth of health care spending. Nonetheless, spending will continue to rise faster than GDP as long as new procedures and drugs appear in profusion and the demand for the better health and longer lives that these innovations are believed to produce remains high.

Options for dealing with Medicare spending within the current structure focus on ratcheting down reimbursement rates, increasing co-payments and deductibles, raising Part B and Part D premiums for more affluent retirees, and enhancing incentives to utilize more cost-effective care. An increase in the payroll tax rate would bring more revenues into the system. Bolder options include providing “premium support” so that all recipients could purchase a basic health plan but no more or creating a new earmarked tax—perhaps a value-added tax—tied to rising health care costs that would require voters to face up to the actual cost of the health care they wish to consume.

Medicaid spending is a federal-state program serving low-income enrollees. But Medicaid spending for the elderly is dominated by the soaring costs of long-term care. Hence, reforms would have to focus primarily on that portion of the program.

Beyond these program-specific options, a more drastic solution would be to reorient social insurance to focus less on universal coverage and more on the needs of low-income individuals and families. While these groups would continue to enjoy full, publicly-funded security, many others would be asked to save more for routine health needs and retirement and to purchase private insurance in a reformed marketplace to cover catastrophic events such as disability, long-term care, and extraordinary medical expenses. These requirements could be publicly supported on a sliding scale, with moderate-income families receiving matches for their savings and subsidies to offset a portion of their premium costs, and upper-income families assuming full responsibility for themselves.

None of these changes would be easy; all would arouse vociferous opposition. Indeed, members of our group disagree about the best way forward, and some would object in principle to some of the options mentioned in this section. Our purpose is not to present solutions but rather to set in motion a process that will yield an outcome that ultimately only the people and their representatives can craft.

That process does not exist today. We must face up to the fact that our current course is unsustainable and begin to discuss alternatives. This is unlikely to happen as long as entitlements continue on autopilot without any mechanism for forcing the political process to make the explicit choices needed to close the long-term gap between spending and revenues.

Conclusion

While we have differing perspectives within our group on the mix of government spending, taxes, and debt conducive to a strong economy and a secure society, we are in full agreement on the following points:

- Current budget policy cannot continue and threatens the future health and vigor of the American economy.
- Delaying hard decisions is both risky and irresponsible toward those who come after us.
- The automatic funding of Social Security, Medicare, and Medicaid impedes explicit consideration of competing priorities and threatens to squeeze out spending for younger people (including investment in their health, skills, and preparations for productive lives) and other investments in future growth (such as research and development and infrastructure). The tax code is also on autopilot and badly needs to be reformed.
- There are no politically painless solutions and neither the government nor the public is facing up to the hard choices that must be made if the country is to continue to prosper and meet its obligations at home and abroad.

Meeting this challenge requires establishing new ways of making spending and tax decisions. The newly-elected president and Congress must work together across party lines to achieve these ends.

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